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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1955

No. 249

JOSEPH E. SHEARER and GEORGIA P. SHEARER,
Petitioners,

vs.

JAMES G. SMYTH, United States Collector of Internal Revenue,
Respondent.

PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals
for the Ninth Circuit.

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OPINIONS BELOW.

The opinion of the Court of Appeals is reported at 221 Fed. 2d 478. The opinion of the District Court is reported at 116 F. Supp. 230.

JURISDICTION.

The judgment of the Court of Appeals here sought to be reviewed was dated and entered on April 22, 1955. Jurisdiction in this Court to review the said judgment by writ of certiorari is conferred by Title 28 USC 1254(1), this petition being filed within the time prescribed by Title 28 USC 2101(c).

QUESTION PRESENTED.

This case presents the question as to whether the gain derived on the sale of certain real estate acquired by Mr. and Mrs. Shearer in 1939 for use as a personal residence, for truck farming and for investment, and sold by them in 1946, should be taxed as ordinary income or as capital gain.

The question is: was this real estate held by Mr. and Mrs. Shearer "primarily for sale to customers in the ordinary course of . . . trade or business" within the meaning of that phrase as used in sections 117(a)(1) and 117(j) of the Internal Revenue Code of 1939, as amended (see Appendix).

The petitioners contend that the law applicable to the factual situation presented by this case is that the real estate was not held by them "primarily for sale to customers in the ordinary course of . . . trade or business", and therefore that the gain derived on sale should be taxed as capital gain rather than as ordinary income. The petitioners contend that the Court of Appeals for the Ninth Circuit, in deciding

to the contrary, has rendered a decision in conflict with the decisions of other courts of appeal on the same matter.

This case involves sections 117(a)(1) and 117(j) of the Internal Revenue Code of 1939, as amended and as applicable to the year 1946 (26 USC 1946 ed., Sec. 117); and sections 29.117-1 and 29.117-7 of Treasury Regulations 111, as amended and applicable to the year 1946. The pertinent text of the applicable statute and regulations is set forth in the Appendix.

STATEMENT OF THE CASE.

Petitioners brought this action in the United States District Court for the Northern District of California to recover Federal income taxes for the year 1946, together with interest thereon. As husband and wife, residents of California, each had filed a separate income tax return for 1946. On or before March 15, 1950 each filed a claim for refund. Notices of disallowance dated September 13, 1951, were sent to the petitioners by registered mail. Within the time provided for in section 3772 of the Internal Revenue Code of 1939, on September 18, 1951, the petitioners brought this action in the District Court. Jurisdiction in the District Court was conferred by 28 USC 1340.

In February 1939, Mr. and Mrs. Shearer acquired, in exchange for their personal residence located in

Palo Alto, California (R. 36),* 19.5 acres of land in the town of Atherton, California. Prior thereto, from 1919 to 1926, petitioner Joseph Shearer had truck farmed this land (R. 35-36). The Shearers purchased the said land in 1939 for three purposes: for use as a residence, for truck farming, and as a long-term investment.

An ordinance adopted by the Town of Atherton in 1939 precluded the Shearers from truck farming the land. From 1939 to and including 1944, the Shearers raised hay on the said land under a share-crop arrangement, using their share of the hay as feed for their cattle (R. 46).

The Shearers were prevented from building a personal residence on the said land by wartime restrictions on construction (R. 65). In 1943-1944, petitioner Georgia P. Shearer became seriously ill with pneumonia and was advised to live in the drier climate of Los Altos, California, rather than in Atherton. In 1944, the Shearers decided to liquidate their investment in the said Atherton land.

Commencing in the latter part of 1944, the petitioners attempted to sell the said Atherton land as a unit. The only offer received for the land was an offer to exchange for the land an office building worth less than the cost to the petitioners of the Atherton land. In 1945, petitioner Joseph Shearer was advised by a town councilman that if he wanted to liquidate

*Numbers in parentheses refer to pages of the printed record, petitioners having elected to file copies herewith under Rule 21(4).

his investment in the Atherton land, the best thing to do would be to subdivide it immediately, because the Town of Atherton was at that time drafting an ordinance to increase the minimum size of subdivision lots in that area from 28,500 square feet to one acre (R. 49). Not having been able to make a satisfactory sale of the land as a unit, the petitioners decided that the only prudent way to liquidate their investment in the Atherton land was by means of subdivision and sale (R. 48-49).

Petitioner Joseph Shearer in 1945 arranged for the subdivision and necessary improvements. The land was subdivided into 25 lots. The required improvements were made at a cost of $24,822. The lots were advertised for sale (R. 77, 80-82). Of the 25 lots, 24 were sold before the end of 1946. The net gain realized by the petitioners from the sale of these 24 lots was $34,254.72. Petitioner Georgia P. Shearer devoted no time or effort whatsoever to either the subdivision of the Atherton land or the sale of the lots into which it was divided (R. 83). Petitioner Joseph Shearer arranged for the subdivision and improvement of the property; and gave not more than five per cent of his time to the sale of the lots, devoting no more than a number of Sunday afternoons to such sales (R. 50-51).

With the proceeds derived from the liquidation of their investment in the said Atherton land by way of subdivision and sale, the petitioners purchased three income-producing real properties which they

still own and hold for investment, not for sale (R. 51-52).

The petitioners, or either of them, have never subdivided for sale any real estate other than the said Atherton land (R. 52). The subdivision and sale of the said Atherton land, which commenced in 1945 and was practically completed by the end of 1946, was the one isolated single instance in which the petitioners subdivided and sold real estate (R. 52). The petitioners, or either of them, have never at any time bought real estate with the intention of subdividing it for sale (R. 52).

The petitioners at all times here material have owned and held for investment and income, and for use in farming and cattle-raising, substantial amounts of real estate, including the Atherton land here in issue (R. 42-47). Except for the said Atherton land, the petitioners still own, and hold for investment and use, not for sale, all of the real estate which they owned at the end of 1945 (R. 43-45).

The petitioners, or either of them, have not at any time engaged in an ordinary course of trade or business as dealers in real estate (R. 37). In addition to devoting the major part of their time to farming and cattle-raising (R. 33-36, 43-45, 56-57), the petitioners during the years here material conducted, on a part-time basis, a real estate brokerage business in which they sold property for others, earning commission income for their services (R. 36-37). In this brokerage business, the petitioners did not purchase real estate for resale, except that, during the fourteen

year period 1939-1953, it was in three isolated instances necessary for the petitioners to purchase property on their own account in order to close sales and thereby obtain commission income (R. 37-43).

In the face of the facts as above set forth, the Court of Appeals for the Ninth Circuit affirmed the conclusion of the District Court that

> "Commencing in 1945 with the subdivision of Atherton Tract, plaintiffs held the property primarily for sale to customers in the ordinary course of their trade or business."

As will be shown in the next following section, this decision is in direct conflict with decisions of the Courts of Appeals for the Second, Seventh and Eighth Circuits.

ARGUMENT.

1. THE CONFLICT OF DECISIONS.

A. The Decisions of the Second, Seventh and Eighth Circuit Courts of Appeals (and of the Tax Court of the United States).

In *Phipps v. Commissioner of Internal Revenue* CCA-2, 54 Fed. 2d 469, the question presented was identical with the question here presented: whether or not real estate which had been disposed of by means of subdivision and sale was property "held by the taxpayer primarily for sale in the course of his trade or business" within the meaning of Federal income tax law. The facts in that case were as follows:

1. The taxpayers purchased a tract of unimproved "jungle" land at Palm Beach, Florida, in 1916.

2. Soon thereafter, the taxpayers had the tract cleared and graded, surveyed and platted into about 70 lots, ornamented with trees, and furnished with roads, water, sewers and electricity. Total cost was $143,255.45.

3. Sales of lots were made over several years, commencing in 1916, all of the lots being sold by October, 1929. In 1924 and 1925, the years in question, these sales yielded profits of $42,367.74 and $41,948.35, respectively.

4. *The evidence did not disclose that the taxpayers had in any other instance disposed of an investment in real estate by way of subdivision and sale. It would appear that only in this one instance did they liquidate an investment in real estate by subdivision, improvement and sale.*

The Board of Tax Appeals in the *Phipps* case, 19 BTA 1293, had sustained the Commissioner of Internal Revenue in denying capital gain treatment with respect to the profits realized on the sales of lots in 1924 and 1925. The Board concluded that the evidence clearly showed that the property was held by the taxpayers primarily for sale in the course of their business. The Second Circuit Court felt compelled to reverse the Board, and Judge Augustus Hand, speaking for the Court, reasoned as follows (54 F. 2d 469 at pp. 470-471):

"If it be argued that the sales of these lots when taken with the purchases and sales of other land we have mentioned were sufficient to amount to a business in real estate, the answer is that any real estate transactions which occurred in 1924 and 1925 were too limited to amount to a business in real estate. . . . While the purchases were made with the hope of profitable sales at some future time they do not seem to have been sufficiently engrossing, to give the taxpayers the vocation of real estate dealers or operators in 1924 or 1925. . . . There should be a greater continuity and larger absorption of time in such transactions to make the taxpayers more than investors. . . . *They had not continuously engaged in the development and sale, or the purchase and sale of lands. Mente v. Eisner,* 266 F. 161; *Cadwalader v. Lederer,* 274 F. 753; *Bedell v. Comm'r.,* 30 F. (2d) 622; *Rogers v. U. S.,* 41 F. (2d) 865; *Washburn v. Comm'r.,* 51 F. (2d) 949; *Heiner v. Tindle,* 276 U.S. 582." [Text italics supplied.]

The Court of Appeals for the Seventh Circuit cited and followed *Phipps v. Commissioner,* supra, in the recent case, *Chicago Title and Trust Co. v. U. S.,* CCA-7, 209 Fed. 2d 773 (1954), the opinion reading in part as follows:

". . . regular operation of a business requires such continuity and expenditure of time in the transactions as to indicate a permanent engagement in the business . . ."

The Court of Appeals for the Eighth Circuit in *Dillon v. Commissioner,* 213 Fed. 2d 218, decided that,

where the taxpayer decided in 1945 to liquidate an investment in 20 houses, and in 1946 advertised the houses for sale and sold the houses in 20 separate transactions. deriving net gain of $45,408.41 from such sales, this was not sufficient to constitute a trade or business under section 117 of the Internal Revenue Code of 1939. Tax Court decision to the contrary (T.C. Memo., 1953, Prentice-Hall T.C. Memo. Service, para. 53,099) reversed. (See Tax Court's Findings of Fact, which show that the taxpayer had been in the business of building and selling houses.)

The Court of Appeals for the Fifth Circuit, in *United States v. Robinson,* 129 Fed. 2d 297, 300, criticized the decisions of the Ninth Circuit on the point here at issue, and cited *Phipps v. Commissioner,* supra, in support of its criticism. See also the very recent decision of the Fifth Circuit in *Smith v. Dunn,* CCA-5, No. 15368, June 30, 1955, reported at 1955 Prentice-Hall Federal Tax Service, para. 72,822, which reversed the District Court and criticized the District Court's charge to the jury. The District Court's charge to the jury reflected the concept of the law as developed in the Ninth Circuit (see the *Ehrman* and *Palos Verdes* cases, infra), and the Fifth Circuit reversed.

The Tax Court of the United States cited and followed *Phipps v. Commissioner,* supra, in the recent case, *Schwerin Trust,* T. C. Memo. (1954), Prentice-Hall T. C. Memo. Service, para. 54,069. In *Schwerin Trust,* the facts show sales in one year of 16 lots yielding a net gain of $40,695.83, plus a sale in the

same year of an 80 acre tract yielding a net gain of $35,200.97.

In another recent Tax Court case, *Daniel W. Ellis,* T. C. Memo. (1954), Prentice-Hall T. C. Memo Service, para. 54,021, the facts were as follows: In 1935 the taxpayer inherited a tract of 166 acres located about three miles southwest of Charleston, South Carolina. Prior to 1946 the tract was used as agricultural land. In 1946, the taxpayer subdivided 44 acres of the tract into 72 lots suitable for home building. An engineering firm was hired to survey and establish lines for the subdivision. The work of putting the lots in condition for residential use consisted of putting in five streets, draining and cleaning ditches, installation of culverts, removal of trees and bushes, etc. The taxpayer employed an agent to supervise the subdivision and handle sales. Sale of the lots was advertised. In 1946, 56 lots were sold; in 1947, 8 lots; in 1948, 5 lots. All of the sales were made either by the taxpayer or his agent. The net gain from the sale of lots was $16,182.81 in 1946; $6,981.62 in 1947; and $2,312.24 in 1948. The tax years in litigation were 1946, 1947 and 1948.

The Tax Court, on the basis of the facts as above set forth, found and decided that the taxpayer should not be considered to have been engaged in the trade or business of selling real estate in the years in question. In deciding the *Ellis* case, the Tax Court said:

> "At the outset the inquiry may be narrowed to the question whether the sales made by the petitioner or on his behalf were in the *ordinary*

course of his business, since it is obvious from our findings of fact that between 1946 and 1948, the lots in petitioner's subdivision were held by him primarily for sale. In order to determine whether the petitioner was engaged in a business when he subdivided and sold a part of the real property he inherited, his conduct must be measured by the standards which have evolved from the numerous cases dealing with this question. The more important criteria in this determination are the reason for the taxpayer's acquiring the property in question; the sales activity of the taxpayer or those acting on his behalf, such as improving the property, soliciting sales by advertising or more direct approach to prospective buyers; the continuity of sales or sales-related activity over a period of time; and the number, frequency and substantiality of sales. *Considered in the light of these criteria we do not think that the activities of the petitioner were such that he should be considered as having been engaged in the trade of business of selling real estate in the years in question."* [Italics supplied.]

On the basis of the foregoing analysis of the cases in the Second, Seventh and Eighth Circuits, and in the Tax Court, it would seem apparent that, in the instant case, the decision in those Circuits and in the Tax Court would have been that the Shearers did not hold the Atherton land primarily for sale to customers in the ordinary course of their trade or business, despite the fact of subdivision and sale. Applying the rationale of the decisions above discussed to the facts of the instant case, the conclusion would have to be

that in the instant case there was not a sufficient quantum of sales and sales-related activity over a sufficient period of time to constitute the subdivision and sale an "ordinary course of trade or business".

B. The Decisions of the Ninth Circuit Court of Appeals.

In *Ehrman v. Commissioner of Internal Revenue*, CCA-9, 120 Fed. 2d 607, 610, the Court of Appeals for the Ninth Circuit said:

> "The sole question is—were the taxpayers in the business of subdividing real estate? If they were, then it seems indisputable that the property constituted 'property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business'."

In *Palos Verdes Corp. v. U. S.*, CCA-9, 201 Fed. 2d 256, the Court of Appeals for the Ninth Circuit laid down the proposition that if a real estate investment is liquidated by means of subdivision and sale, *the use of this method of disposal requires the conclusion that the property is held for sale "to customers in the ordinary course of trade or business of real estate."*

On the basis of these Ninth Circuit decisions, the defendant in the instant case (the respondent here) argued on brief that

> "The law is well settled in the Ninth Circuit that where property is subdivided and active steps are taken to sell the lots in such subdivision to separate purchasers, a taxpayer holds that property 'primarily for sale to customers in the ordinary course of his trade or business'."

Petitioners, on the basis of the Ninth Circuit's decision in the instant case, cannot help but agree that the respondent's analysis of the Ninth Circuit's position with respect to the point at issue is quite correct.

In the instant case, the quantum of activity, the substantiality of the sales, and the period of time required to complete the liquidation of the investment by way of subdivision and sale was far less than in the *Phipps* case, supra, and about the same as in the *Dillon, Schwerin Trust* and *Ellis* cases, supra.

It is to be noted that in the instant case the District Court in its opinion did not choose even to mention, much less attempt to distinguish the *Phipps* and *Ellis* cases, despite the fact that both cases are directly in point and were stressed in the reply brief filed by the plaintiffs (the petitioners here). Nor did the Court of Appeals for the Ninth Circuit mention or attempt to distinguish the several cases from the other Circuits and from the Tax Court hereinabove discussed, although all of these several cases were called to the attention of the Court of Appeals either on brief or in oral argument. The decision of the District Court, affirmed by the Court of Appeals, that

> "The disposition of the Atherton tract by plaintiffs was of such size and called for such substantial investment and devotion of time as to place it outside the scope of a capital transaction"

is obviously in direct conflict with the several cases from the other Circuits and from the Tax Court hereinabove discussed, particularly with the Second Cir-

cuit's decision in the *Phipps* case and the Tax Court's decision in the *Ellis* case, supra.

One final point with reference to the conflict of decisions remains to be made. The subdivision and sale in the instant case could not possibly be held to constitute "an ordinary course of trade or business" within the meaning of that phrase as used in section 117 of the Internal Revenue Code of 1939, under the language above-quoted from the decision of the Court of Appeals for the Seventh Circuit in *Chicago Title and Trust Co. v. U. S.*, supra. And yet, in the instant case, the Court of Appeals for the Ninth Circuit affirmed the ultimate finding and conclusion of the District Court that:

> "Commencing in 1945 with the subdivision of the Atherton tract, plaintiffs held the property primarily for sale to customers in the ordinary course of their trade or business."

II. FACT THAT PETITIONERS WERE REAL ESTATE BROKERS IS OF NO SIGNIFICANCE.

The fact that the petitioners devoted part of their time to a real estate brokerage business, in which they earned commission income for selling property owned by others, is of no significance as a factor in the case. Even had the petitioners been "dealers" (which the facts of record show they were not), such fact would be of no significance in view of the District Court's finding that the Atherton land was acquired and held by the petitioners, until its liquidation and sale, for personal use, for truck farming, and

as a long-term investment. *Dillon v. Commissioner,* CCA-8, supra. In the *Dillon* case, the facts as found by the Tax Court show that the taxpayer had been in the business of building and selling houses. See also, *Stern Brothers & Co. v. Comm'r.,* 16 T.C. 295, 313, acquiesced to by the Commissioner, Cum. Bulletin 1951-2, p. 4.

The focal point of the conflict between the Ninth Circuit on the one hand and the Second, Seventh and Eighth Circuits (and the Tax Court) on the other is the affirmance by the Ninth Circuit of the District Court's ultimate finding in the instant case that:

> "Commencing in 1945 with the subdivision of Atherton tract, plaintiffs held the property primarily for sale to customers in the ordinary course of their trade or business."

Petitioners request the Court to consider all of the facts of record and to draw its own ultimate conclusion therefrom.

III. THE STATUS OF THE DISTRICT COURT'S ULTIMATE FINDING ON APPEAL AND REVIEW.

The question as to whether a gain was or was not realized by the taxpayer "in the ordinary course of his trade or business", within the meaning of that phrase as used in section 117 of the Internal Revenue Code of 1939 is a mixed question of law and fact; and even though the trial Court designates its conclusion with respect to such question as an ultimate finding of fact, it nevertheless constitutes a conclusion of

law subject to review. On the issue here presented, this Court may consider the facts of record and draw its own ultimate conclusion therefrom.

U. S. v. United States Gypsum Co., 333 U.S. 364, 394-395;

Comm'r. v. Smith, CCA-2, 203 Fed. 2d 310, 311;

McGah v. Comm'r., CCA-9, 210 Fed. 2d 769;

Washburn v. Comm'r., CCA-8, 51 Fed. 2d 949, 951;

Dillon v. Commissioner, CCA-8, 213 Fed. 2d 218;

Smith v. Dunn, CCA-5, No. 15368, June 30, 1955.

CONCLUSION.

It is respectfully submitted that certiorari should be granted in the present case to settle the conflict between the decision of the Court of Appeals for the Ninth Circuit in this case and the decisions of the Courts of Appeals for the Second, Seventh, and Eighth Circuits; and it is further respectfully submitted that the decision of the Court of Appeals in this case should be reversed.

Dated, San Francisco, California,
July 18, 1955.

WILLARD C. MILLS,
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(Appendix Follows.)